

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 99-0057
Indiana Adjusted Gross Income Tax
For Tax Years 1995 through 1997**

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ISSUES

I. Adjusted Gross Income Tax: Partnership Distributions

Authority: IRC §63;
IC 6-3-2-1

Taxpayer protests the Department's characterization of income received from an Indiana partnership.

II. Tax Administration: Negligence Penalty

Authority: IC 6-8-10-2.1;
45 IAC 15-11-2

Taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer provides financial products and services to individual and institutional investors. Additionally, Taxpayer offers investment and banking services to corporate, governmental, and municipal clients.

In 1985, Taxpayer formed an Indiana partnership ("Partnership"). The stated purpose behind formation of the Partnership was to purchase, rehabilitate, and market residential buildings in downtown Indianapolis. Taxpayer's *planned* participation in the Partnership consisted, primarily, of bond underwriting and equity syndication. Taxpayer, as the initial equity investor (\$6.5 million capital investment), intended to offer limited interests in the Partnership to its retail customers. (The general partner was an unrelated third party.) Taxpayer also intended to reserve, for itself, a limited interest in the Partnership.

Taxpayer's partnership plans proved untenable. Federal tax law changed. The residential real estate market weakened. The general partner, a local builder, declared bankruptcy. Limited

partnership interests could not be sold. Consequently, Taxpayer chose to retain its ninety-nine percent (99%) limited partnership interest. A new general partner, an affiliated corporation, acquired the remaining one-percent (1%) partnership interest. Additional limited partners were never found.

Despite the absence of outside investors, the Partnership, over the next eleven (11) years, operated as intended; the Partnership rehabilitated residential properties. The Partnership operations, though, were not profitable. Taxpayer continued to fund the Partnership's residential real estate activities. Taxpayer "advanced" the Partnership \$31 million. For federal income tax purposes, Taxpayer characterized the \$31 million "advancements" as capital contributions (i.e., equity). Taxpayer explains:

For federal tax purposes...the advances did not possess sufficient characteristics of debt and were therefore treated as equity. Annual losses were recognized [by Taxpayer] for federal tax purposes because the additional equity contributions gave the company sufficient tax basis to claim such losses.

In 1996, Taxpayer liquidated the Partnership. According to Taxpayer, the liquidation proceeds were sufficient to return Taxpayer's initial capital investment of \$6.5 million. The liquidation proceeds, however, were insufficient to "cover" any of Taxpayer's \$31 million "advancements." The proper characterization of these liquidation proceeds is at issue.

Taxpayer *initially* characterized the \$31 million liquidation proceeds as income. Taxpayer explains:

[Taxpayer's] department that prepared the [Partnership's] returns used the financial statement information that included the COD income [received by Taxpayer from the Partnership] as the basis for amounts reported on the [federal] return. This department was unaware that the appropriate federal tax treatment of the transaction was different from the treatment on the financial statement and included COD income of approximately \$31 million on the partnership return as additional rental income.

Furthermore (again, according to Taxpayer):

The [Partnership's] federal partnership return, Schedule K-1, erroneously reported partnership income of \$26,423,497 that included \$31 million of COD income. ... Building on the mistake on the K-1, Taxpayer's tax compliance group deducted \$26,423,497 as foreign source income before apportionment on Taxpayer's Indiana Corporate Income Tax Return....

Upon review, Audit disallowed Taxpayer's \$26,423,497 foreign source income deduction. Audit re-characterized the \$26,423,497 as non-unitary partnership income. Accordingly, Audit allocated the entire amount to Indiana. These adjustments "resulted in a significant increase to [Taxpayer's] Indiana adjusted gross income." Specifically, Audit proposed an additional \$1,966,645 of assessments. Taxpayer protests these additional assessments.

DISCUSSION

I. Adjusted Gross Income Tax: Partnership Distributions

This assessment is based on Audit's disallowance of the foreign source income deduction and subsequent re-characterization of the reported income as non-unitary partnership income. Audit explains:

During the audit period, the [T]axpayer [received]...distributions from...an Indiana partnership [Partnership]. The distributions were reported on line 31 of Schedule B as other adjustments before apportionment. The [T]axpayer failed to add back non-unitary partnership distributions attributed to Indiana on line 37.

Taxpayer does not directly contest either Audit's disallowance of the foreign source income deduction, or Audit's subsequent re-characterization of the income as non-unitary partnership income. Rather, taxpayer contends the amounts in question were not "income."

Taxpayer explains:

[Taxpayer] treated certain book accounting entries related to contributions of capital improperly as partnership rental income. For federal income tax purposes, the book accounting entries erroneous characterization does not cause federal taxable income. In the case of a partner and its partnership, the Internal Revenue Code classifies the amount in question as contributions of capital. Return of capital does not result in IRC §63 taxable income to the recipient.

The threshold question, then, is whether the amounts reported as income by Taxpayer (and subsequently re-characterized as non-unitary partnership income by Audit—i.e., the liquidation proceeds), were, in fact, income. If the reported amounts were income, then the Department must determine whether this income should have been apportioned as unitary partnership income, or allocated to Indiana as non-unitary partnership income.

The Liquidation Proceeds

Despite Taxpayer's initial characterization of the liquidation proceeds as "partnership rental income," the underlying transactions belie such a portrayal. The Partnership, while in operation, never realized \$31 million in rental income. Consequently, the liquidation proceeds could not, when in the hands of Taxpayer (a corporate partner), be characterized as rental income.

Similarly, Taxpayer's "advancements" did not represent loans to the partnership. The Partnership, upon liquidation did not realize \$31 million of income from the cancellation of debt. Consequently, the liquidation proceeds could not, when in the hands of Taxpayer (a corporate partner), be characterized as cancellation of debt income.

The \$31 million of "advancements" transferred to the Partnership by Taxpayer are best characterized as contributions of capital. Amounts characterized as "return of capital" do not

represent “income.” See IRC §63 and IC 6-3-2-1. While the amounts denominated as “liquidation proceeds” were sufficient to guarantee a return on Taxpayer’s initial capital contribution, these proceeds failed to cover (or return) Taxpayer’s subsequent capital contributions. Taxpayer, that is, failed to realize income when it received the liquidation proceeds. And absent realization, Taxpayer has nothing to recognize.

FINDING

Taxpayer’s protest is sustained.

II. Tax Administration: Negligence Penalty

The Department may impose, in certain situations, a ten percent (10%) negligence penalty. IC 6-8-10-2.1 and 45 IAC 15-11-2. Taxpayer’s failure to timely file income tax returns, generally, will result in penalty assessment. IC 6-8.1-10-2.1(a)(1). The Department, however, may waive the penalty if Taxpayer can establish that its failure to file “was due to reasonable cause and not due to negligence.” 45 IAC 15-11-2(c). A Taxpayer may demonstrate reasonable cause by showing “that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed....” *Id.* Since Taxpayer has prevailed on the only issue upon which this penalty was assessed, the penalty must be waived.

FINDING

Taxpayer’s protest is sustained.